Office of Chief Counsel
Internal Revenue Service

memorandum

CC: [redacted]:TL-N-696-99
[redacted]

date: MAR 04 1999

to: Assistant Chief Counsel (Field Service) CC:DOM:FS

from: District Counsel, [redacted] District, [redacted]

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subject: [redacted] & Subsidiaries
[redacted]
TIN: [redacted]

Please review the following proposed advisory opinion for legal sufficiency. The opinion is written generically and contains no identifying or sensitive information (beyond the subject caption above) that should not be released.

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement.

FACTS

During [redacted], Corporation X, a domestic corporation, requested the assistance of the United States competent authority as the result of an adjustment initiated by the Internal Revenue Service for the tax years ending December 31, [redacted], through December 31, [redacted]. The adjustment concerns the determination and application of transfer pricing methodologies (TPM's) for certain international transactions between itself and its foreign parent.

Further, Corporation X requested an Advance Pricing Agreement (APA) with the Internal Revenue Service to cover these transactions for the prospective years [redacted] through [redacted] to avoid this recurring issue. In its submission for an APA, Corporation X also requested

that any cost sharing methodology (CSM), agreed to under mutual agreement between the U.S. and [redacted] Competent Authorities, be applied retrospectively to the years of [redacted] through [redacted].

Ultimately, the U.S. and [redacted] competent authority reached an agreement which was presented to Corporation X. This agreement was not rejected by the taxpayer and, thus, was accepted pursuant to the provisions of Rev. Proc. 91-23, 1991-1 C.B. 534, § 11.05. The Assistant Commissioner (International) also approved such agreement. Further, Corporation X and the Internal Revenue Service executed an APA covering the proposed TPM, including its retrospective application. A copy of the APA is attached as Exhibit B. The terms of the APA were included with the agreement with the [redacted] competent authority.

Pursuant to the above agreements, the Internal Revenue Service desires to make an assessment of tax arising from the items that were the subject of the competent authority agreement and the APA without issuing a notice of deficiency. Neither agreement contains a waiver of the deficiency procedures of § 6213(a). Further, such agreements have not been incorporated into either a closing agreement within the meaning of § 7121 nor a Form 870 (Waiver of Restrictions on Assessments of Collection). Corporation X, has subsequently refused to execute a Form 870 or closing agreement contending that other items not currently under examination may eliminate the agreed deficiency.

ISSUE

Whether the Internal Revenue Service may assess a tax arising from adjustments to specific items agreed to in a competent authority agreement and an APA without obtaining a Form 870, entering into a closing agreement, or issuing a statutory notice of deficiency?

BRIEF ANSWER

Generally, an assessment of tax may not be made unless, within the three-year limitations period, the Internal Revenue Service mails to the taxpayer a notice of deficiency apprizing the taxpayer of his right to file a petition for review by the Tax Court. I.R.C. § 6213(a). This restriction on assessment of a proposed deficiency only applies to those deficiencies the Secretary is authorized to issue a notice of deficiency pursuant to § 6212(a). Section 6212(a) authorizes the Secretary to send a notice only in those cases where the 'Secretary' determines that there is a deficiency. In contrast, in the case of competent authority resolution or an APA, it is not the 'Secretary' who determines that there is a deficiency; rather, it is an agreement between the

Secretary and the taxpayer. Thus, the restrictions on assessment detailed by §§ 6212 & 6213 are inapplicable to the Secretary's general authority to make an assessment. This conclusion is consistent with the positions taken in Rev. Proc. 91-22, 1991-1 I.R.B. 526, and Rev. Proc. 91-23, 1991-1 C.B. 534, that such agreements are not subject to administrative or judicial review. *See* Rev. Proc. 91-23 § 11.05.

DISCUSSION

In general, an APA is an agreement between the taxpayer and the Internal Revenue Service that binds the taxpayer to a defined transfer pricing methodology and that provides, in return, that if the conditions of the agreement are satisfied, the Internal Revenue Service will not challenge on audit, whether the transactions between the taxpayer and a related party covered by the agreement have been conducted at arm's length. At the heart of an APA is the agreement among the tax authorities to give effect to the approved transfer pricing methodology (TPM). Such agreement procedures were formalized in Rev. Proc. 91-22, 1991-1 I.R.B. 526.[1] The primary benefit of seeking an APA is to obtain certainty of result with respect to a defined set of transactions by applying an agreed TPM to transactions of the parties to the agreement for a defined term of years. Section 9 of Rev. Proc. 91-22 states that the APA will be a binding agreement between the taxpayer and the Service. As long as the taxpayer complies with the terms and conditions of the APA, the Internal Revenue Service will treat the results of applying the TPM as satisfying the arm's length standard and, except as provided in the agreement and the revenue procedure, the Internal Revenue Service will not contest the application of the TPM to the matters covered by the APA.

Similarly, when the U.S. competent authority and a foreign competent authority agree to discuss an allegation of double taxation under the mutual agreement procedure article of a treaty, the United States will attempt to reach an agreement that is acceptable to the United States, to the treaty country, to the taxpayer and to any relevant person related to the taxpayer. Rev. Proc. 91-23, 1991-1 C.B. 534, § 2.03. The Tax Treaty Division assists the Assistant Commissioner (International) in this function. Rev. Proc. 91-23 § 2.04. The Division analyzes mutual agreement procedure requests, secures additional information from the taxpayer or Internal Revenue Service district offices, and coordinates all efforts in providing a developed case for entering

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[1] Although Rev. Proc. 91-22 was suspended by Rev. Proc. 96-13, 1996-13 IRB 3, this revenue procedure was in effect at the time.

into negotiations with the foreign competent authority. I.R.M. 42(10)(11).9(1). In appropriate circumstances, such as occurred in this case, the Service will enter into an agreement regarding an APA with a foreign competent authority. Rev. Proc. 91-22 § 2.

A taxpayer requesting assistance under Rev. Proc. 91-23 will be notified of any agreement or partial agreement between the U.S. and the foreign competent authorities. Rev. Proc. 91-23, § 11.05. Subject to the taxpayer's acceptance, the Assistant Commissioner (International) ultimately approves any agreement reached with the foreign treaty country. If such agreement or partial agreement is not acceptable to the taxpayer, the taxpayer may withdraw the request for competent authority assistance and then pursue all rights otherwise available under U.S. or foreign laws. Id. If accepted by the taxpayer, the agreement is not subject to administrative or judicial review. Id.

When appropriate, the taxpayer will be requested to enter into a closing agreement reflecting the terms of the assistance provided by the competent authorities. Rev. Proc. 91-23 § 11.05. In this case a closing agreement was not secured by the Service. Apparently, the National Office will not initiate such an agreement without either a taxpayer request or overriding circumstance.

Normally an assessment may not be made unless, within the three-year limitations period, the Internal Revenue Service mails to the taxpayer a notice of deficiency apprizing the taxpayer of her right to file a petition for review in the Tax Court. I.R.C. § 6213(a). This restriction on the assessment of a deficiency only applies to those deficiencies the Secretary is authorized to issue a notice of deficiency pursuant to § 6212(a). I.R.C. § 6213(a). Section 6212(a) authorizes the Secretary to send a notice only in those cases where the 'Secretary' determines that there is a deficiency. This is not such a case. To explain, in the case of a APA and a competent authority agreement, it is not the 'Secretary' who determines that there is a deficiency; rather, it is an agreement between the Secretary and the taxpayer. Thus, the restrictions on assessment detailed by §§ 6212 & 6213 are inapplicable to the Secretary's general authority to make an assessment. This construction flows logically from the fact that the purpose of a deficiency notice is to enable the taxpayer to petition the United States Tax Court for redetermination of a proposed deficiency without first having to pay the tax. By contrast, a competent authority agreement which incorporates the retrospective application of an APA, by definition, is to provide the final and conclusive resolution with respect to the tax liability arising from the specifically named items in the agreement. If the taxpayer accepts the agreement reached, the agreement is not subject to administrative or judicial review.

Rev. Proc. 91-23, § 11.05.

The same rationale was applied in our determination that the Internal Revenue Service was entitled to make an assessment pursuant to a properly formatted closing agreement with respect to several items within the meaning of § 7121 of the Internal Revenue Code without the issuance of a notice of deficiency. A copy of that advisory opinion which was reviewed by Field Service is enclosed as Exhibit A. Significantly, in that opinion, this office discussed Hempel v. United States, 14 F.3d 572 (11th Cir. 1994), for the proposition that, in view of the circumstances surrounding the execution of a closing agreement, it was illogical to read the tax laws as requiring the issuance of a notice of deficiency prior to making an assessment. Id. *at* 577. Significantly, the Court echoed the above statutory construction in reaching its decision. Specifically, the Court stated:

> The purpose of a deficiency notice is to enable the taxpayer to petition the United States Tax Court for redetermination of a deficiency without first having to pay the tax. By contrast, the whole point of the closing agreement in this case was to obviate the need for the taxpayers to litigate in the tax court.... Thus a 90-day letter would have served no rational purpose, whether issued before or after the first anniversary of Sutton.

Hempel *at* 578. Such a statutory construction is equally applicable in the case of APA's and competent authority agreements.

Should you have any questions regarding this memo, please contact [redacted] of our office at [redacted].

[redacted]
District Counsel

[redacted]

By: _____
[redacted]
Attorney

Attachments
Exhibit A: Advisory Opinion dated December 23, 1998.
Exhibit A: APA Between [redacted] & I.R.S.

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:[redacted]:TL-N-7429-98
[redacted]

date: DEC 23 1998

to: Chief Examination Division, [redacted] District
Attn: Large Case Group Manager [redacted]; [redacted]

from: District Counsel, [redacted] District, [redacted]

subject: [redacted] & Subsidiaries
[redacted]

TIN: [redacted]
TL-N-7429-98

This memo is in reply to your request for advice on the issue below.

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

FACTS

Corporation X and the Internal Revenue Service executed a properly formatted closing agreement with respect to several items within the meaning of § 7121 of the Internal Revenue Code that are normally governed by the deficiency procedures of § 6213(a). Pursuant to this agreement, the Internal Revenue Service desires to make an assessment in order to increase the general underpayment rate under § 6601(a) to the "hot interest" rate under § 6621(c). The closing agreement itself does not contain a waiver of the applicable deficiency procedures. Further, a Form 870 (Waivers of Restrictions on Assessments and Collection) was not executed by the parties simultaneously with the signing of the closing agreement.

Corporation X, has subsequently refused to execute a Form 870 contending that other items not currently under examination may eliminate the agreed to deficiency.

ISSUE

Whether the Internal Revenue Service may assess a tax arising from a closing agreement as to a determination covering specific matters without obtaining a Form 870 or issuing a statutory notice of deficiency?

BRIEF ANSWER

Treasury Regulation § 301.7121-1(d)(2) provides that a deficiency or overpayment determined pursuant to a closing agreement shall be assessed and collected or credited and refunded in accordance with applicable provisions of the law. Normally an assessment under applicable tax law may not be made unless, within the three-year limitations period, the Internal Revenue Service mails to the taxpayer a notice of deficiency apprising the taxpayer of her right to file a petition for review by the Tax Court. I.R.C. § 6213(a). However such a restriction on the assessment of a deficiency only applies to those deficiencies the Secretary is authorized to issue a notice of deficiency pursuant to § 6212(a). I.R.C. § 6213(a). Section 6212(a) authorizes the Secretary to send a notice only in those cases where the 'Secretary' determines that there is a deficiency. In contrast, in the case of a closing agreement, it is not the 'Secretary' who determines that there is a deficiency; rather, it is an agreement between the Secretary and the taxpayer. Thus, the restrictions on assessment detailed by §§ 6212 & 6213 are inapplicable to the Secretary's general authority to make an assessment. This conclusion is consistent with Revenue Procedure 68-16, 1968-1 CB 770 whose procedures permit assessment of deficiencies without issuing a statutory notice of deficiency in the case of a closing agreements even without a waiver. *See* Rev. Proc. 68-16 § 8.03.

It is recommended prospectively, that waiver paragraphs be incorporated in every closing agreement to avoid this issue in the future.

DISCUSSION

Generally, the Code provides that the Secretary is authorized to enter a written agreement with any person relating to the liability of such person (or of the person or estate for whom he acts)in respect of any Internal Revenue tax for any taxable period. I.R.C. § 7121(a). After a closing agreement is approved and signed by the Secretary or his delegate, it is final and conclusive unless

a party can show fraud or malfeasance, or misrepresentation of a material fact by the other party. I.R.C. § 7121(b).

A closing agreement cannot be reopened as to any matter specifically agreed upon, nor can the agreement be modified by any officer, employee or agent of the United States. I.R.C. § 7121(b)(1). A closing agreement cannot be annulled, modified, set aside or discarded by any action, suit or proceeding. I.R.C. § 7121(b)(2). Any agreement, determination, assessment, collection, payment, abatement, refund or credit made in accordance with the closing agreement likewise may not be annulled, modified, set aside or discarded. I.R.C. § 7121(b)(2).

A closing agreement must be in writing, contain explicit terms, and meet all of the requirements of the statute. Huddock v. Commissioner, 65 TC 351 (1975); Holland v. Commissioner, 70 T.C. 1046 (1978). Three types of closing agreements have evolved. Form 866 (Agreement as to Final determination of Tax Liability) is used with regard to the total tax liability of a post taxable year. Form 906 (Agreement as to Determination Covering Specific Matters) covers closing agreements as to one or more taxable items affecting liability. Finally, where neither Form 866 nor 906 is appropriate to cover the subject of the closing agreement, it is necessary to type a special agreement which combines the aspects of both forms.

Form 870, Waivers of Restrictions on Assessments and Collection, are frequently submitted with respect to a taxable year covered by a proposed closing agreement. The waiver may be submitted along with either Form 866 or 906 and may be conditioned on the acceptance of the closing agreement. A taxpayer may also be required to file Form 872 (Consent to Extend the Statute of Limitations on Assessment) if the statutory period of limitation for assessment expires within a period of 120 days from the date such closing agreement will be submitted for approval. See Rev. Proc. 68-16 § 8.04.

In this case a Form 870 was not secured with the execution of the closing agreement. The taxpayer in this case contends that without such a waiver, the Internal Revenue Service cannot assess the items governed by the closing agreement without first issuing a statutory notice of deficiency in accordance with the restrictions set forth in § 6213(a) in order to trigger the running of 'hot interest' under § 6621(c). Such a position has no basis in law.

Normally an assessment under applicable tax law may not be made unless, within the three-year limitations period, the Internal Revenue Service mails to the taxpayer a notice of deficiency apprising the taxpayer of her right to file a petition for review by the Tax Court. I.R.C. § 6213(a). However such a restriction on

the assessment of a deficiency only applies to those deficiencies the Secretary is authorized to issue a notice of deficiency pursuant to § 6212(a). I.R.C. § 6213(a). Section 6212(a) authorizes the Secretary to send a notice only in those cases where the 'Secretary' determines that there is a deficiency. This is not such a case. To explain, in the case of a closing agreement, it is not the 'Secretary' who determines that there is a deficiency; rather, it is an agreement between the Secretary and the taxpayer. Thus, the restrictions on assessment detailed by §§ 6212 & 6213 are inapplicable to the Secretary's general authority to make an assessment. This construction flows logically from the fact that the purpose of a deficiency notice is to enable the taxpayer to petition the United States Tax Court for redetermination of a proposed deficiency without first having to pay the tax. By contrast, the closing agreement, by definition, if approved by the Secretary, is to provide the final and conclusive resolution with respect to the tax liability arising from the specifically named items in the agreement without litigation.

Revenue Procedure 68-16, 1968-1 CB 770 which explains procedures applicable to the processing of closing agreements by the Internal Revenue Service embraces this approach. This Rev. Proc. permits the assessment of deficiencies without issuing a statutory notice of deficiency in cases where closing agreements are proposed even without a waiver. *See* Rev. Proc. 68-16 § 8.03. Specifically, the Rev. Proc. states:

> [8].03 Waivers of Restrictions on Assessment
>
> 1. Form 870 and other waivers or restrictions on assessment and collection which are ordinarily signed and submitted by taxpayers pursuant to the provisions of section 6213(d) of the Code will ordinarily be submitted with respect to a taxable period the tax liability for which is being determined by closing agreement (assuming there is a deficiency or over assessment), ***though a waiver is not legally required in order to assess a deficiency without issuance of a statutory notice of deficiency in such cases*** (emphasis added).

Further, although only persuasive authority, § 52.15 Mertens Law of Federal Taxation reinforces this interpretation of law.

The taxpayer's representative has cited Hempel v. United States, 14 F.3d 572 (11th Cir. 1994), for the proposition that an assessment in the absence of a valid waiver in a closing agreement is improper under applicable tax law. We do not agree with this reading of Hempel. In that case the taxpayers executed a closing agreement agreeing to be assessed based on the outcome of a related

litigation at the time. The closing agreement in Hempel contained an express waiver of the statutory notice requirement for any resulting assessment made within a year of the decision in the related case. Hempel *at* 575. The Internal Revenue Service did not make an assessment until two years after the decision of the related case was entered. The Court found the taxpayer's proposed construction of the waiver paragraph (that the I.R.S. had to send a deficiency notice prior to assessment having failed to do so within a year) as manifestly unreasonable for two reasons. First, it was inconsistent with the plain language and structure of the paragraph. Second, even if the conditional waiver paragraph were respected, **it was illogical in view of the circumstances surrounding the execution of the closing agreement.** Id. *at* 577.

Significantly, the Court echoed the above statutory construction in expanding on this second, alternative, basis. Specifically, the Court stated:

> In addition to being inconsistent with the language and structure of paragraph 8, the taxpayers' conditional waiver argument fails the test of practical sense.... The purpose of a deficiency notice is to enable the taxpayer to petition the United States Tax Court for redetermination of a deficiency without first having to pay the tax. By contrast, the whole point of the closing agreement in this case was to obviate the need for the taxpayers to litigate in the tax court.... Thus a 90-day letter would have served no rational purpose, whether issued before or after the first anniversary of Sutton.

Hempel *at* 578.

Despite the above conclusions, it is recommended prospectively, that waiver paragraphs be incorporated in every closing agreement to avoid this dilemma. Such provisions have been respected by the Courts. *See, e.g.*, Brian G. Conway, T.C. Memo 1994-413. Should you have any questions regarding this memo, please contact [redacted] of our office at [redacted]

[redacted]
District Counsel

[redacted]

By: _____
[redacted]
Attorney